DOW THEORY LETTERS INC.

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THE MARKET: With a "landslide" vote, the American people, like Dickens's famed Oliver Twist, have indicated that they want "more." The Johnson victory was very expected, and this observer believes that it is probably all for the best. The odds are heavily in favor of the primary trend turning down during the next year or so. If a primary bear market materialized with the Republicans in office ("shades of Herbert Hoover") it would probably mark the absolute end of the Republican Party in the U.S. It would also bring out the cry of "back to Democratic deficit spending policies," and "back to Government control." For the good of the country I personally feel that all of us should be allowed to see where the policies of the New Deal-Fair Deal take us and how they are resolved. Sooner or later Americans must learn that the Government can only "give" what it takes from the people. Even inflation must literally come out of the hides of the pensioners, the savers and the insurance holders. In his autobiography Bernard Baruch emphasized that "two and two has always equalled four." It remains for the American people to grasp the full significance of that naive little phrase.

For 67 years the Averages have served to reflect the "hard cash opinions" of the nation's investors and businessmen. The Averages are capable of doing the "expected" for months on end; they have also been known to perform the "unexpected" at a moment's notice. One thing can be said with certainty; it has usually proved expensive to argue with the verdict of Wall Street.

As seen on Chart 1, the Industrials have been moving sideways for over two months while the Rail Average has progressed rather steadily to new highs. The last Industrial high was recorded on October 20 at 881.50. The Rail high occurred on October 26 at 224.91. Dow Theorists are watching those two points with great interest. A joint bettering of those highs would reconfirm the primary bull market and indicate that all trends (primary, secondary and minor) are up. Conversely, a persistent refusal by one or both Averages to better the October highs could be the market's way of saying: "Hold it; the way is not quite as clear as the politicians and business leaders would have us believe."

* * * *

Referring to the composite chart, for the past two weeks (despite the flood of bullish business news and despite the virtually unanimous predictions of a Johnson victory) the 10-day average of advances and declines have remained in a state of unusual equilibrium. Thus there has been no strong pressure on the market from either the buyers or the sellers. On November 2, however, the 5-day average of daily new highs dropped to 59, lowest since September 5. This suggests a lack of buying interest, although as seen on the chart, new lows (indicative of selling pressure) have not expanded significantly. The 5-day average of 34 new lows recorded on August 31 stands as the point to watch if selling should enter the market.

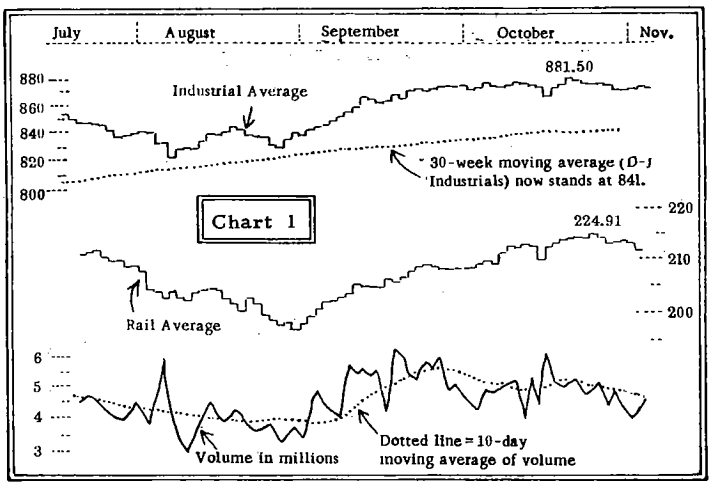
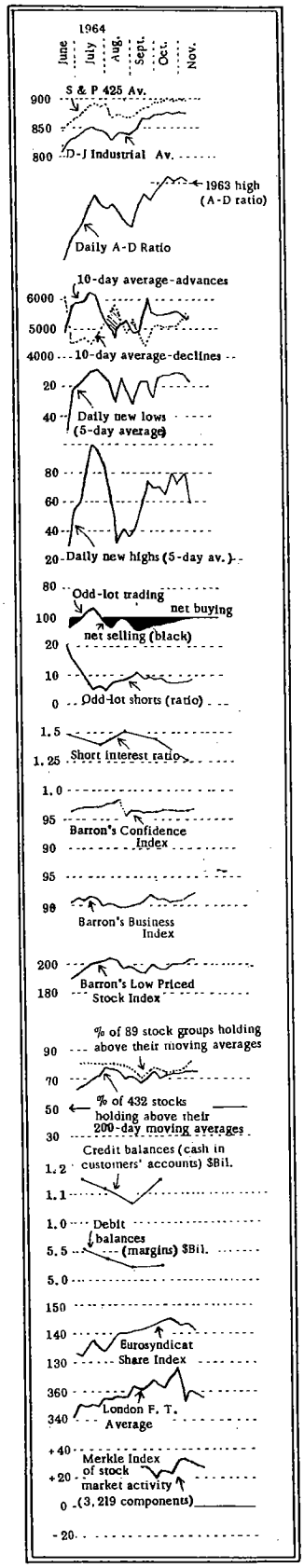


Chart 1: Note the narrow sideways range of the Industrial Average from mid-September to the present. This type of action becomes immediately apparent on semi-logarithmic paper, since semi-log scale measures percentage of change. As seen on the chart, Industrials have actually been "weighing" the situation carefully over the past two months, while Rails have been rising. Volume has tended to recede since September, and this is clearly visible in the 10-day average of volume. Whether the current "line" in the Industrial Average represents distribution of accumulation is a question which should be resolved shortly.

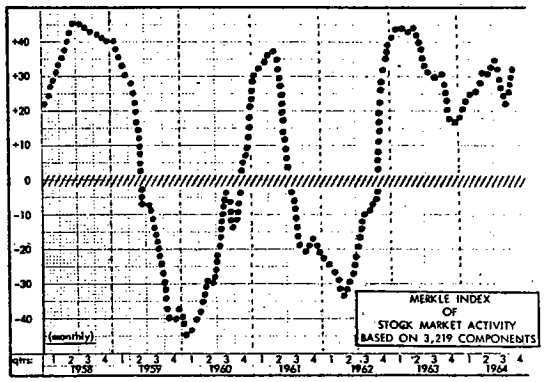
After many months of selling, odd-lotters are now producing enough buying days to keep the 10-day ratio at 100 (i.e., 100 shares bought for every 100 sold). This may mean that the public is getting ready to



enter the market more aggressively. Barron's Confidence Index (C.I.) remains noticeably sluggish, and this Index seems to be saying that it sees no important rise in the period ahead. According to the interpretation of expert Joseph Gravnille, the lead time of the C.I. is two to four months. Since the high for the C.I. was set on August 10, Granville believes that the C.I. is forecasting a top for the Dow in the October 10 to December 10 period (in other words, around now). Of 432 representative stocks which are tabulated here weekly, 323 or 75% are now holding above their moving averages. This is well above the critical 50% level, and the study remains bullish.

THREE NEW INDICATORS: I have added three new indicators to the composite chart. Because the nations of the Free World are now thoroughly interdependent and because international monetary conditions are so much a fact of life today, I have included the famous Stock Average of the London Financial Times. This Average is now particularly interesting, and we note that with the October victory of the Labor Government, the British market has wiped out its entire summer advance and is currently flirting with the low (351) recorded a few weeks ago. The second new indicator is the Eurosyndicat Index which is the average of the 66 largest corporations in the Common Market. We might say that as the Eurosyndicat Index goes, so goes the Common Market.

Finally, I have received permission to include the Merkle Index which is a compilation developed by my friend Dan Merkle, President of Traders Research. I have known Dan for many years; he is a serious and tireless worker, and he is a true market scientist. Dan invented this Index five years ago after four prior years of steady work. The Index is based on detailed analysis of 3,047 stock charts, 131 industry groups and 41 market indicators. No stock averages are used, and all stocks, groups and indicators are processed weekly from the standpoint of both mechanical and subjective analysis and the whole combined into a weekly Index number.



The history of the Merkle Index (monthly) is shown on the accompanying chart. Note the points at which the Index touched a high or low, and note also the points at which the Index broke above or below the critical zero level. Currently, the Merkle Index is moving sideways in plus territory between the plus 45 of early 1963 and the plus 16 of late 1963. The Index is well above the danger level of zero which was last penetrated on the downside during the third quarter of 1961.

With the Standard & Poor 425 Industrial Average closing the month of October at 89.72, the Momentum Index (see Letter 268) has dropped from 118 (September) to 116. Thus this Index is still holding within its downward channel — a long-term bearish consideration.

WHAT ARE THEY THINKING? The writer has followed (and studied) the thinking of many leading market analysts over the years. Every week brings a large collection of market letters to this office (some are received on an "exchange basis," some I subscribe to) and visitors often spend hours here leafing through the back history of other services.

I have often wanted to review the writing and thinking of other men in this field, and since few people can subscribe to 15 or more services, I find myself in the position of being able to offer opinions of many other analyst's works. Because the bull market has progressed so far and over so many years, I feel that this would be a propitious time to inaugurate a series of reviews of the writing of other analysts whose thinking (in my opinion) rates them leaders in the field.

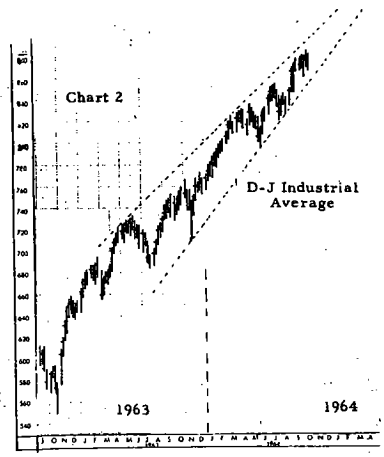
The first gentleman in the series will be Mr. E. George Schaefer of Indianapolis. Schaefer started his "Dow Theory Trader" service in 1948. This analyst possesses a "feel" for the market and an instinct for the big picture second to none. He is one of the very, very few men who fully comprehend the concept of the primary trend. A warning: if you have ever heard Schaefer speak, do not be fooled by his "hoosier-country boy" style of delivery. For Schaefer has been way ahead of the city boys on Wall Street for a long time.

Schaefer provided his readers with many important technical studies during the late 1940's and early 1950's, and he has always labeled himself a "modern Dow Theorist." Schaefer has combined many technical considerations with his reading of the Averages, and I have found his thinking along these lines to be sound.

In my library is a copy of Schaefer's June 18, 1949 report, in which he predicted a major new bull market. His reasoning was brilliant, and if he had never written anything else, he would rate a "superb" on this one alone. Personally, I wish that Schaefer had continued with his earlier technical studies, but those were written when the technical approach (and, in fact, almost any approach) was rare, and it is possible that he is now a bit tired of the "teaching" approach which was a feature of his earlier letters.

Ever since 1949 (when he first "called" the bull market) Schaefer has been of the opinion that this market would end like most other bull markets — in a speculative "blow off." With this thought firmly in mind, Schaefer stubbornly maintained that the primary bull market was intact during the reaction of 1953, during 1957, during 1959 and even in 1962. He was convinced that there would be a monumental blow off before the great bull market finally gave up the ghost.

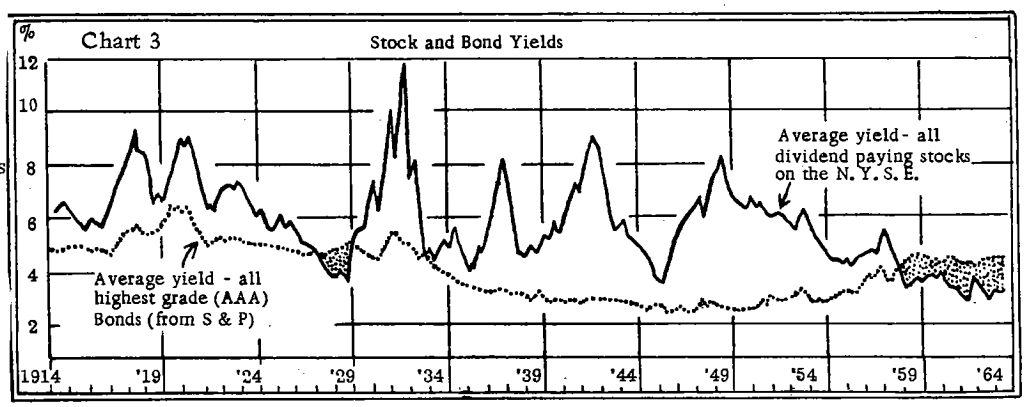
Two weeks ago Schaefer drew attention to the great "spearpoint" triangle formation (Chart 2) now clearly visible in the Industrial Average. He is of the opinion that the Industrial Average will push out of the triangle on the upside — coincident with a probable final blow off. Then Schaefer said something that I have not seen him say before. If the Industrials (instead of rising) now drop below the lower trendline of the triangle and then below the 200-day moving average which is now about 835 (and if this drop takes place in the face of good news — not scare news), then Schaefer feels that we could conceivably be seeing the beginning of a primary bear market. At any rate, to my knowledge, this is the first time that Schaefer has been cautious enough to put his readers on alert for a possible bear market level in the Averages.



This long-time bull is undoubtedly beginning to get cautious. He believes the great post-war bull market could terminate sometime in 1965. He also believes that the eventual bear market may be a whopper — perhaps taking the Dow back to the 200 to 300 range.

Next Week: Joseph Granville.

YIELDS: One of the truly fundamental market studies is that of the yield cycles in common stocks and in bonds — and the relationship of these two cycles. Periodic comments regarding yields have been offered in this Service over the past six years. For the benefit of the many new new subscribers, I believe that this would be an opportune time to up-date the yield cycle study.



The accompanying Chart 3 traces average yields on all dividend paying common stocks (N.Y.S.E.) from 1914 to the present. The chart also shows average yields on all AAA (i.e., Standard & Poor's highest grade) bonds during the same period.

One thing stands out clearly, and that is that during the great majority of years since 1914, average common stock yields were considerably higher than average bond yields. Only twice during the last 51 years was this "normal" relationship reversed. The first instance occurred during 1928 and 1929, at which time average bond yields (see chart) held in the 4½ to 5% range while yields on common stocks plunged below 4% (this is represented by the shaded area on the chart). Following this unusual period, the yield relationship reversed again. The bear market of 1929-32 produced its own extremes, and during 1932 an extraordinary yield spread of 7% (in favor of bonds) developed. Thus the abnormal yield relationship of 1928-29 was offset in 1932 by what was probably the widest yield spread (in favor of bonds) in history.

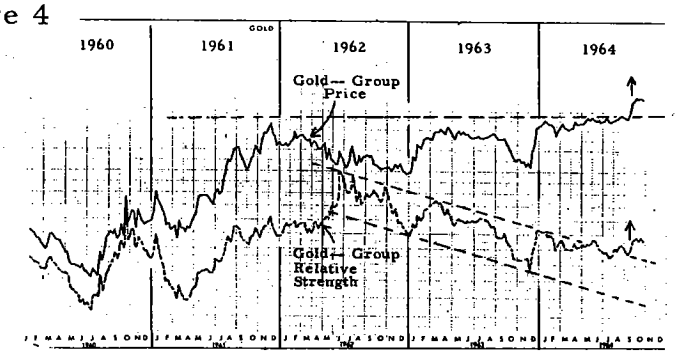
All through the 1930's, '40's and '50's the normal yield relationship (i.e., stocks yielding more than bonds) continued. Then in late 1958, for the first time in 29 years, bond yields climbed above stock yields again. As seen on the chart, this so-called "inverse spread" has held sway from 1958 to the present. Even the 1962 crash failed to push common stock yields above bond yields.

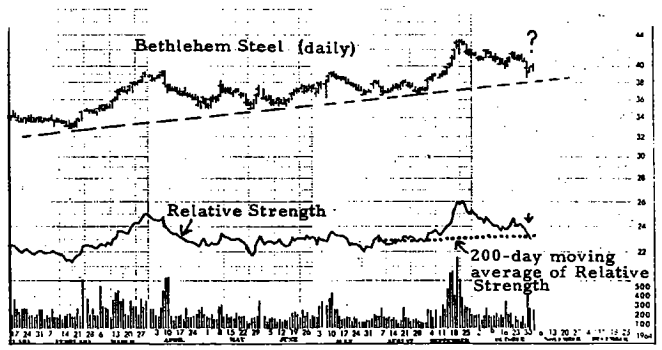
The bull market of 1921-29 lasted eight years. During the last two years of that bull market (1928-29) the inverse yield spread appeared. Those two years correspond with the third or speculative phase of 1921-29 bull market. In the current case, the bull market has lasted from 1949 to the present (fifteen years).

An inverse yield spread has been a fact of Wall Street life for the past six years. The amazing persistence of this yield relationship should serve to make any investor pause, look and ponder. For we are now in a third phase which has extended beyond anything witnessed during any previous bull market in American history. One cannot but wonder whether the aftermath of the current shaded area on the chart will be anything like the previous one.

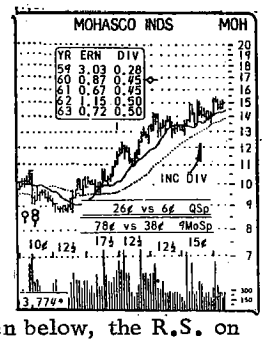
STOCKS: I have asked myself why U.S. mutual funds do not purchase golds. One reason could be the thin supply. For instance, Dome Mines has only 1.9 million shares outstanding; Campbell Red Lake 4.0 million; American South African 1.2 million; Giant Yellow Knife 4.3 million. These figures represent total shares outstanding, not the "floating supply" which is considerably less in each case (total shares outstanding minus stock "put away" in vaults and held by insiders, directors, etc., equals floating supply).

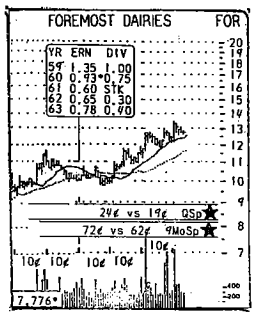
Recommended new gold purchases: Campbell Red Lake, Giant Yellow Knife, Free State Geduld (the last is a South African gold yielding around 8% and selling around 9 times earnings). It is the richest gold mine in South Africa.



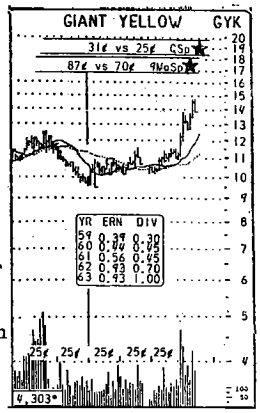


The chart above brings us up to date in the Gold Group. As previously noted (Letter 263) the Gold Group has recorded a new high each year since 1960. The Group is currently around its 1964 high, and the three year trend of declining relative strength has reversed to the upside (as seen on the chart). In the next Letter: The case for the South African Golds.



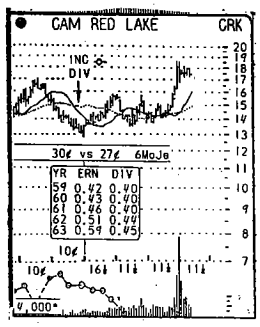


Bethlehem Steel, previously recommended, continues to be one of the better acting steels — but that may not be enough (see chart). Seven out of twelve leading steel companies in the Traders Research book now show relative strength (R.S.) breaking below the 200-day moving average of R.S. This is not a hopeful indication. As seen below, the R.S. on Bethlehem is very slightly below the 200-day M.A., and this is a warning signal. If BS now drops below its long trendline (below 38) it should be sold, but the current action constitutes a warning for BS holders and all holders of steel stocks. Steels in which the R.S. lines are now in a bearish relationship: Colorado Fuel, Crucible, Armco, Alleghany Lud., Jones Laughlin, Lukens, U.S., Wheeling. Something is "wrong" in steels (could it be a Johnson "lid" on steel prices?).

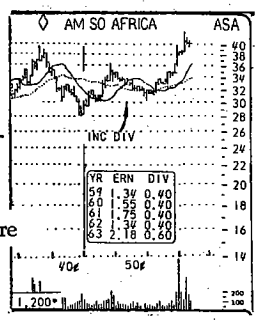


Burroughs is continuing to attract insider buying. Latest figures (October) show two officers purchasing 3,000 shares from Burrough's treasury. The stock is hanging on — holding just above its 10-week moving average at 26 (see chart). Mohasco Industries, a low priced speculation which was recommended at 13 back in Letter 248 still looks good. A director (through a holding company) purchased 6,000 shares of MOH in October. Earnings for MOH have about doubled in the past nine months, and the stock is still an interesting speculation Foremost Dairies (Letter 267) shows four officers buying 7,700 shares during October. The stock is holding nicely above its 10-week moving average which is now 10½.

Giant Yellow Knife (recommended repeatedly) is a Canadian gold which pays a $1 dividend. The stock has moved up sharply since I recommended it, but volume has not yet become excessive. Note the "buying interest" (i.e., volume) as GYK pushes out on the weekly chart. When a stock pushes up on big volume, then holds its ground as volume simmers down, it is exhibiting superb technical action. It is only when the stock loses previous ground gained as volume contracts that the action can be considered poor. Study the charts of ASA, GYK, CRK. Note how they have held their gains as volume has dwindled. This is good action, and these stocks should now be ready to move again.



I want to emphasize again that every subscriber should have at least a few representative gold stocks in his account. If you need yield, such stocks as President Brand and Free States Geduld probably represent the best values, all things considered, of any equity now available anywhere. I view the current move in gold stocks as part of a primary movement, which, unlike the rise in the rest of the market, is still in its infancy.



LATE NOTES: (Written early Thursday, November 5). Our market celebrated the Johnson victory by closing off for the day. A curious soberness has come over Wall Street as some of the immediate problems begin to capture the spotlight. Yesterday, London closed off 7.2 (equal to 18 points here), and a new low for the post-election decline has been recorded. London's market is saying that Prime Minister Wilson has only begun to do what he has to do to reverse the British balance-of-payments mess. At the same time that the British market is breaking, Sweden has announced a rise in her bank rate, a full percentage point to 5½%. The pressure to higher interest rates continues, with only the U.S. and England remaining "immune" (see Letter 260 on international interest rates).

Charts of the Gold Average and BS courtesy of Traders Research, 1431 Pearl Ave., Alton, Illinois 62003. Small weekly charts courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas.

Note: Suggested reading — write to Economist's National Committee on Monetary Policy, 79 Madison Ave., N.Y.C. 16 for "Results of 25 Years of the Great American Inflation" by the brilliant Melchior Palyi (a pamphlet which I believe is free).